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Internal Revenue Service  
**Memorandum**

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subject: Katrina, Rita, and Wilma NOL Questions

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent. This memorandum addresses certain questions relating to NOLs attributable to Hurricanes Katrina, Rita, or Wilma posed by Service personnel from Atlanta and Austin. This memorandum does not address questions that relate only to the application of section 165 to casualty losses.

The questions posed refer to casualty losses without drawing any distinction between the different types of losses attributable to the various hurricanes that damaged the gulf coast in 2005. However, most of the questions relate to Gulf Opportunity Zone Losses (GO Zone losses). Only casualty losses that meet the definition of qualified Gulf Opportunity Zone casualty losses (QGOZCL) may generate GO Zone losses. The portion of an NOL that qualifies as a GO Zone loss qualifies for a 5 taxable year carryback period. A GO Zone loss may be generated by five types of deductions one of which is a deduction for a QGOZCL.

Section 1400N(k)(3) defines a QGOZCL as any uncompensated 1231 loss (as defined in section 1231(a)(3)(B)) of property located in the Gulf Opportunity Zone (GO Zone) (1)

if such loss is deductible under section 165 for the taxable year and (2) such loss is by reason of Hurricane Katrina. Section 1231(a)(3)(B) losses include certain losses pertaining to property used in a trade or business or certain losses associated with certain capital assets held for more than one year in connection with a trade or business or a transaction entered into for profit. Consequently, casualty losses of property held for personal use cannot generate a GO Zone loss. Likewise, losses of property not located in the "GO Zone", as defined in section 1400M(1), or caused by Hurricanes Wilma or Rita rather than Hurricane Katrina, cannot generate a GO Zone loss.

Most of the NOL questions submitted appeared to assume that the casualty loss at issue constitutes a QGOZCL. Unless stated otherwise, each of our answers assumes that type of casualty loss.

### **Comments on Statements by the Field**

#### **1. The loss can be taken in 2004 or 2005.**

Correct except for certain QGOZCLs.

Section 165(i) allows taxpayers to elect to take certain losses attributable to disasters into account for federal income tax purposes for the taxable year immediately preceding the taxable year in which the disaster occurred. Losses eligible for the election generally include any loss attributable to a disaster occurring in an area subsequently determined by the President of the United States to warrant assistance by the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act. Therefore, if the casualty loss was attributable to Hurricane Katrina, Rita, or Wilma and was incurred in the GO Zone, Rita GO Zone, or Wilma GO Zone, the taxpayer is generally entitled to make a section 165(i) election with regard to the loss. The section 165(i) election allows the taxpayer to treat the loss as incurred in 2004 rather than 2005.

However, section 1400N(k)(3)(C), in conjunction with section 1400N(k)(2)(B)(i), provides that section 165(i) shall not apply to any QGOZCL to the extent such loss is taken into account in determining the amount of a GO Zone loss. The apparent purpose of this provision is to ensure that "[t]o the extent that a casualty loss is included in the eligible NOL and carried back [as a GO Zone loss], the taxpayer is not eligible to also treat the loss as having occurred in the prior taxable year under section 165(i)." Staff of the Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of H.R. 4440, The "Gulf Opportunity Zone Act of 2005" as Passed by the House of Representatives and the Senate, at 26 JCX-88-05 (Dec. 16, 2005).

It is not clear why Congress decided to restrict a taxpayer's right to make a section 165(i) election for QGOZCLs if its purpose was to ensure that such losses could not be deducted for the prior taxable year and also deducted for purposes of determining the amount of the current taxable year GO Zone loss. Making a section 165(i) election causes the loss to be treated as incurred in the prior taxable year for federal income tax

purposes, which prevents it from being taken into account in determining the amount of a GO Zone loss for the current taxable year. Nevertheless, the restriction on making section 165(i) elections for QGOZCLs is the law and must be applied.

The mechanics of applying this restriction, however, are far from self-evident. There are at least two possible interpretations to these statutory provisions. First, provided that the deductions at issue are allowable in computing an NOL, it may be demonstrated that all of those deductions are necessary to produce the actual amount of the NOL. That is, a reduction in any of the taxpayer's deductions would result in a corresponding reduction in the taxpayer's NOL until eliminated. Likewise, if a taxpayer has an NOL that qualifies as a GO Zone loss and also has deductions for QGOZCLs, reducing the amount of the taxpayer's deductions for QGOZCLs results in a corresponding reduction of the taxpayer's NOL until eliminated. Because of this, a strong argument can be made that if any portion of an NOL qualifies as a GO Zone loss, a section 165(i) election cannot be made with regard to any of the taxpayer's QGOZCLs. This is the most straightforward reading of the statute, but it can lead to harsh results if the taxpayer has a small GO Zone loss but a large amount of QGOZCLs that would otherwise be eligible for a section 165(i) election.

Second, one could interpret the restriction as only applying to the extent of the actual GO Zone loss. This appears to be the view taken by the Joint Committee Staff. See page 26 of the Technical Explanation. Taking this approach would require adopting an ordering rule to determine which deductions eligible to generate a GO Zone loss are treated as offsetting gross income and which deductions are treated as actually generating the loss. Under this interpretation QGOZCLs that offset gross income would be eligible for the section 165(i) election and those which are treated as actually generating the NOL would not be eligible for the section 165(i) election.

Upon adopting an ordering rule, applying the second interpretation is straightforward if all of the QGOZCLs are treated as offsetting gross income (the section 165(i) election applies to all of the QGOZCLs) or if all of the QGOZCLs are treated as generating the NOL (none of the QGOZCLs are eligible for the section 165(i) election). Implementing the second interpretation presents complications if part of the QGOZCLs offset gross income and part of them generate the NOL.

For example, a taxpayer has \$ 5,000 of gross income and \$10,000 of QGOZCLs. Thus, prior to any section 165(i) election, the taxpayer has a \$5,000 NOL all of which qualifies as a GO Zone loss. In this instance \$5,000 of the taxpayer's QGOZCLs are treated as offsetting gross income and \$5,000 of the QGOZCLs are treated as generating the GO Zone loss. At first glance then it appears that \$5,000 of the QGOZCLs qualify for the section 165(i) election and \$5,000 of them do not. However, if the taxpayer makes a section 165(i) election with regard to \$5,000 of the QGOZCLs, the deduction for those losses will be taken into account for the prior taxable year rather than the current taxable year. This change means that the remaining \$5,000 of QGOZCLs no longer produce an NOL which qualifies as a GO Zone loss but simply offset gross income for

the current taxable year. Arguably, this qualifies the remaining \$5,000 of QGOZCLs for the section 165(i) election. If a section 165(i) election with respect to any casualty loss has the effect of qualifying additional QGOZCLs for the section 165(i) election, it may be demonstrated that if any of the QGOZCLs qualify for the section 165(i) election all of the QGOZCLs qualify for the section 165(i) election.

Under the second interpretation, the section 1400N(k)(3)(C) prohibition on making a section 165(i) election applies to a taxpayer's QGOZCLs only if all of the QGOZCLs are treated as generating the taxpayer's NOL. If this is not the case the taxpayer may make a section 165(i) election with regard to all of the taxpayer's QGOZCLs. In determining whether a taxpayer's QGOZCLs generate an NOL, the QGOZCLs should be treated as taken into account last in computing the NOL unless there are other deductions, such as allocable interest deductions attributable to a certified equity reduction transaction, that take priority over QGOZCLs in determining the character of the NOL.

We believe the Service should adopt the second interpretation in applying the limitations on making section 165(i) elections with regard to QGOZCLs. This interpretation avoids the harsh results that may occur under the first interpretation. It does not run afoul of Congress' intent that the taxpayer not obtain the benefits of a section 165(i) election and a 5 taxable year NOL carryback period with regard to the same loss. This interpretation also harmonizes with the rule that when a taxpayer makes a section 165(i) election the casualty is treated as if it actually occurred in the preceding taxable year. See section 165(i)(2); Treas. Reg. §1.165-11(d). In other words, under section 165(i) a taxpayer is prohibited from treating part of its losses attributable to a disaster as occurring in the actual year of the disaster and the remainder of its losses attributable to that disaster as occurring in the preceding taxable year.

**2. If taken in 2004 the loss may not generate a GO Zone Loss. However, It may generate an NOL that qualifies for a 3 taxable year carryback period under section 172(b)(1)(F).**

Correct. Section 1400N(k), which defines and addresses the application of GO Zone Losses, is effective for losses arising in taxable years ending on or after August 28, 2005. Therefore, a taxpayer may not incur a GO Zone Loss for calendar year 2004.

For individual taxpayers section 172(b)(1)(F)(i), in conjunction with section 172(b)(1)(F)(ii), provides a 3 taxable year carryback period for the portion of any NOL generated by deductions for losses of property arising from fire, storm, shipwreck, or other casualty or from theft. Pursuant to section 1400N(k)(3)(A), a QGOZCL must be attributable to Hurricane Katrina (a major storm). Therefore, if a taxpayer elects under section 165(i) to treat a QGOZCL incurred in 2005 as if incurred in 2004, to the extent that loss generates an NOL, the NOL will qualify for a 3 taxable year carryback period under section 172(b)(1)(F).

**3. If the loss is claimed in 2005, the taxpayer can elect to treat it as a Go Zone Loss and carry it back 5 years rather than an eligible loss with a 3-year carryback.**

Not exactly. Section 1400N(k)(1) provides for a 5 taxable year carryback period for a GO Zone loss (section 1400N(k)(1)(A)(i)), prevents the loss from being taken into account in determining how much of an NOL qualifies for the 3 taxable year carryback period (section 1400N(k)(1)(A)(ii)), and removes the 90 percent of AMTI limitation on the allowance of such losses in computing AMTI (section 1400N(k)(1)(B)). Section 1400N(k)(4) provides in part that rules similar to those in section 172(i)(3) shall apply with respect to a GO Zone loss. This raises the question of whether an election made pursuant to section 1400N(k)(4) prevents the application of all of the provisions of section 1400N(k)(1) or simply waives the 5 taxable year carryback period provided for by section 1400N(k)(1)(A)(i).

Section 172(i)(3) provides that a taxpayer may elect to have the carryback period for a farming loss determined without regard to section 172(b)(1)(G). Section 172(b)(1)(G) provides for a 5 taxable year carryback period for the portion of an NOL that qualifies as a farming loss. There is very little legislative history on the GO Zone loss waiver. The Staff of the Joint Committee Print simply indicates that an election may be made to waive the 5 taxable year carryback period. See page 26 of the Technical Explanation. Finally, we note that with regard to an analogous provision, the 5 taxable year carryback period for NOLs incurred in taxable years ending in 2001 or 2002, the waiver statute only provides for the waiver of the 5 taxable year carryback period. The waiver does not affect the exemption of the deduction of such losses from the 90 percent of AMTI limitation. See sections 172(b)(1)(H), 172(j), and 56(d)(1).

Because the cross-referenced statute, section 172(i)(3), only deals with the waiver of the carryback period, because the Joint Committee Print only specifically talks about the waiver of the 5 taxable year carryback period, and because of how the analogous provisions relating to the special rules for 2001 and 2002 NOLs apply, we believe that the election provided by section 1400N(k)(4) only results in the waiver of the 5 taxable year carryback period for GO Zone losses. The election does not otherwise change the character of or alter the tax treatment of the loss. Consequently, even if the election is made, the amount of the GO Zone loss determined for AMT purposes will still be exempt from the 90 percent of AMTI deduction limitation. The GO Zone loss will also continue to be subject to section 1400N(k)(1)(A)(ii), making it ineligible for the 3 taxable year carryback period provided for by section 172(b)(1)(F). Therefore, if a taxpayer waives the 5 taxable year carryback period with regard to a Go Zone loss, that loss is carried back under the normal 2 taxable year carryback rule of section 172(b)(1)(A)(i).

### **Questions**

**1.a Do the extended due dates also extend the date for filing the election to forgo the carryback period?**

Yes. Section 172(i)(3) provides that an election to waive the 5 taxable year carryback period for a farming loss shall be made in such manner as may be prescribed by the Secretary of the Treasury, and shall be made by the due date (including extensions of time) for filing the taxpayer's return for the taxable year of the NOL. Section 1400N(k)(4) provides in part that rules similar to those in section 172(i)(3) shall apply with respect to a GO Zone loss. Likewise, the section 172(b)(3) election to waive all of the carryback periods with regard to an NOL must be made by the extended due date of the return.

Section 7508A authorizes the IRS to postpone deadlines for certain time-sensitive acts, including the filing of federal income tax returns, for up to one year for taxpayers the IRS determines are affected by a Presidentially declared disaster. If a taxpayer qualifies for an extended federal income tax return filing due date for a taxable year pursuant to section 7508A, the taxpayer may also make a timely election to waive carryback periods for any NOL incurred in that taxable year by the extended due date.

**1.b What can we accept for a valid election? Is a chart just showing the amount to go forward acceptable?**

No. Each of the statutory provisions providing for the waiver of any carryback period pertaining to any portion of an NOL requires that the election be made in the manner specified by the Secretary of the Treasury. To date, the only regulations that have been issued that address the waiver of NOL carryback periods pertain to the section 172(b)(3) election to waive all of the carryback periods pertaining to an NOL, an election that traces its origins to the Tax Reform Act of 1976. With regard to that election, Treas. Reg. § 301.9100-12T(d) provides:

Unless otherwise provided in the return or in a form accompanying a return for the taxable year, the elections described\* \* \* shall be made by a statement attached to the return (or amended return) for the taxable year. The statement required when making an election pursuant to this section shall indicate the section under which the election is being made and shall set forth information to identify the election, the period for which it applies, and the taxpayer's basis or entitlement for making the election.

The case law dealing with elections to waive NOL carryback periods generally address what it is required, pursuant to section 172(b)(3), to waive all of the carryback periods with regard to an NOL<sup>1</sup>. To date, no case has addressed the requirements to waive one of the special NOL carryback periods such as that pertaining to a GO Zone loss. Nevertheless, the principles established in the section 172(b)(3) waiver cases also apply to elections to waive special NOL carryback periods.

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<sup>1</sup> Some of the cases address the issue of whether a taxpayer may make a "split election" with regard to a regular tax NOL and an AMT NOL. Those cases are not relevant to this issue.

A section 172(b)(3) election to waive all of the carryback periods with respect to an NOL “must be *unequivocal* and *unambiguous*.” *Powers v. Commissioner*, 43 F.3d 172, 176 (5<sup>th</sup> Cir. 1995). In the absence of a line item or check off block on a tax form to indicate waiver of the carryback period, this intent is communicated by an express and unambiguous written statement from the taxpayer indicating that the taxpayer is foregoing the carryback period. A taxpayer’s method of reporting an NOL on the taxpayer’s tax returns does not constitute a binding election with regard to that NOL. In *Garland v. Commissioner*, T.C.Memo 1993-190, the taxpayers noted NOL carryovers on their Schedule C forms for various taxable years but did not file any timely statements electing to forego the carryback period with regard to such NOLs. Under these circumstances, no valid election to forego the carryback periods was made.

Showing the amount of an NOL carryover on a chart, even if the chart is attached to a timely filed return for the taxable year the NOL is incurred, does not constitute a valid section 172(b)(3) election to forego all of the carryback periods with regard to that NOL. Simply showing the amount of NOL carryover on a chart does not even allow a reader of the chart to infer that the taxpayer might desire to waive the carryback period. The carryover may be attributable to the fact that there is no modified taxable income in the carryback years available to absorb any portion of the NOL. *Cf. Young v. Commissioner*, 783 F.2d 1201 (5<sup>th</sup> Cir. 1986) (including the amount of an NOL carryover on a minimum tax form failed to indicate why the NOL was being carried over).

A taxpayer might include a very detailed NOL absorption chart with the tax return for the taxable year of the NOL. Such a chart typically shows both the modified taxable income for all of the potential carryback years as well as the identity and amount of any NOLs absorbed in those years. If the chart showed unabsorbed modified taxable income in taxable years to which the NOL could be carried back, without any of the NOL being absorbed in those years, this would at least justify speculation that the taxpayer planned to carry the NOL only forward and not back. Nevertheless, such a chart would not constitute an express statement binding the taxpayer to a course of action. Even if the taxpayer subsequently only carried the NOL forward this action would not qualify as an election. A taxpayer’s treatment of an NOL does not constitute an election with regard to that NOL.

Likewise, if a taxpayer only carries an NOL back 2 taxable years when that NOL is eligible for a 5 taxable year carryback, and shows this carryback on a schedule attached to a timely filed return for the taxable year the NOL is incurred, the taxpayer’s actions do not constitute a waiver of the 5 taxable year carryback period. The taxpayer’s actions are just an erroneous treatment of the NOL. To waive an NOL carryback period a taxpayer must do so expressly.

- 2. If the loss is claimed on the 2005 return, does the TP have the choice to carry it back 3 years (eligible loss) or 5 years (GO Zone Loss)?**

See the above discussion under **Comments on Statements by the Field** item number 3. A GO Zone loss does not qualify as an eligible loss. If a taxpayer elects to waive the 5 taxable year carryback period for a GO Zone loss the taxpayer may only carry the loss back 2 taxable years under the normal carryback rule.

**3. How are we to determine what the TP is electing to do as far as actual NOL carrybacks? Do they have to specifically say I am electing.. or is the filing of the correct form with a 3 or 5 year carryback sufficient?**

See the above discussion under **Comments on Statements by the Field** item number 3. A GO Zone loss does not qualify as an eligible loss. If the taxpayer does not timely elect to waive the 5 taxable year carryback period for a GO Zone loss the taxpayer must first carry the loss back to the 5<sup>th</sup> preceding taxable year. If the taxpayer files a timely election to waive the 5 taxable year carryback period, but does not elect to waive all of the carryback periods, the taxpayer must carry the loss back under the normal 2 taxable year carryback rule.